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Financial Markets

Irving Trust

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Over the last two weeks, market participants have become transfixed by the possibility that interest rates might really make a significant move to lower levels. The change in mood has been triggered by some steady declines in M1, the narrowest monetary aggregate, and indications that the broader aggregates, M2 and M3, might show very sluggish growth in April. Some have begun to talk of the prospect that the Fed might even cut the discount rate soon. Cutting the discount rate would be an act of pure discretion at this time: The Fed is not being pressured by events or by the Administration to lower rates now. It therefore seems more likely to me that rates will hold at current levels and that a backup might even occur.

The economy is not crying out for further stimulus at this time and does not provide a reason to lower rates. Perhaps it is surprising, but housing starts are holding up well, even at current interest rates. Auto sales are picking up, albeit with interest rate subsidies. The prospect of substantial government deficit spending underpins notions that real GNP will continue to move forward this year. And, further stimulus will come with the mid-year tax cut.

Further stimulus at this time might trigger inflation. In any event, as this recovery builds, prices will rise despite the strong dollar and low oil prices. The President's program to support agricultural prices will add to inflation. By year-end, we might be seeing some inflation statistics considerably worse than the recent ones. The Fed is probably crafting policy now to anticipate that possibility.

The "prospect" of lower monetary growth is an illusory lure to lower rates. Everyone has known that April would bring the strongest seasonals ever to damp money growth --and the job has been done. But what about after April and the seasonal revisions that will strengthen money growth? Surely the Fed would prefer to wait and see if April money is a seasonal or a fundamental phenomenon.

If we look further ahead there are other reasons to see why the Fed should wait to lower rates. It is a bit hard to imagine that a cut in interest rates soon could sustain a declining trend through the presidential elections in 1984. Yet it is also hard to foresee the Fed raising rates in the teeth of a presidential election campaign, with unemployment still very high. More logically, interest rates should be expected to remain firm until late this year or early next, when both the political and economic cycles will be calling for a shot in the arm for the economy.

Were the Fed to lower rates soon, it's very possible that long rates might even back up as they did early in the year. Furthermore, the progress on the long end of the rate structure makes further Fed action unnecessary for now. But the short rates have clearly run ahead in search of a discount rate cut. Some of this can be explained by "supply" problems. Banks, flush with MMDA funds, have reduced their CDs outstanding from $141 billion in early December to $104 billion. Commercial paper is down from $173 billion to $167 billion over the same period. Thus, the scarcity of open market paper has played a role in reducing yields, narrowing spreads against short-term Treasury issues, and flattening the yield curve. CDs can't continue to trade below the funds rate, however, unless expectations of a discount rate cut persist. These expectations could erode over the coming weeks, and short-term rates move back up. Optimism should be tempered with caution at this time.

Robert A. Brusca

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Market Yields

	5/6/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	16.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	8.38	8.75	14.88
Repurchase Agreements	8.38	8.50	14.50
U.S. Treasury Issues			
Bills			
3 months	8.30	8.30	12.80
6 months	8.43	8.56	13.24
1 year	8.59	8.71	13.30
Coupons			
2 years	9.23	9.36	13.66
4 years	9.63	9.74	13.64
7 years	10.08	10.14	13.58
10 years	10.16	10.27	13.48
Long Bond	10.30	10.38	13.09
Negotiable Certificates of Deposit-Secondary Market			
1 month	8.30	8.30	14.20
3 months	8.35	8.35	13.75
6 months	8.30	8.45	13.60
1 year	8.70	8.90	13.50
Banker's Acceptances			
1 month	8.31	8.46	14.20
3 months	8.33	8.43	13.70
6 months	8.39	8.55	13.50
Eurodollar Deposits			
1 month	8.69	8.81	14.88
2 months	8.75	8.88	14.63
3 months	8.75	8.88	14.44
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.51	8.63	14.62
1 month	8.42	8.56	14.24
3 months	8.41	8.54	13.89
Bank Holding Companies			
1 month	8.17	8.17	14.10
Dealer Placed:			
3 months	8.44	8.56	14.17
New AA Corporate Utility Bond	10.88	11.60	15.75
Tax Exempt			
6 month Project Notes	4.70	4.80	7.40
1 year AAA Bond	5.00	4.75	7.50
5 year AAA Bond	6.30	6.30	9.25
20 year AAA Bond	8.30	8.20	11.60

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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